



0000120757

BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN

COMMISSIONER - CHAIRMAN

RENZ D. JENNINGS

COMMISSIONER

CARL J. KUNASEK

COMMISSIONER

DOCKETED

MAR 16 1998

DOCKETED BY

IN THE MATTER OF THE COMPETITION IN) DOCKET NO. RE-00000F-94-0165
 THE PROVISION OF ELECTRIC SERVICES) INITIAL BRIEF OF PG&E
 THROUGHOUT THE STATE OF ARIZONA.) ENERGY SERVICES CORPORATION

INTRODUCTION

Pursuant to the Chief Hearing Officer's directive, PG&E Energy Services Corporation ("Energy Services") hereby submits its Initial Brief in connection with the "stranded cost" hearings recently concluded in the above-captioned proceeding. As requested by Mr. Rudibaugh, the discussion set forth below will be organized so as to address the issues identified in the December 1, 1997 Procedural Order ("Procedural Order") and the December 11, 1997 First Amended Procedural Order ("First Amended Procedural Order") in the manner therein presented. In addition to reiteration of the position of Energy Services, as presented through the testimony of Douglas A. Oglesby, Energy Services will also discuss certain of the suggestions made or concerns expressed by others during the course of the hearings.

DISCUSSION

Issue No. 1: Should the Electric Competition Rules be modified regarding stranded costs?
If so, how?

Answer: Yes. See discussion below.

A. A.A.C. R14-2-1607 (B) should be clarified to provide that Affected Utilities will be afforded an opportunity, but not a guarantee, to recover legitimate, verifiable, and, non-mitigatable stranded costs. As a number of witnesses have acknowledged during the

MUNGER CHADWICK, P.L.C.
 ATTORNEYS AT LAW
 NATIONAL BANK PLAZA
 333 NORTH WILMOT, SUITE 300
 TUCSON, ARIZONA 85711
 (520) 721-1900

1 hearings, under current regulation in Arizona incumbent electric utilities are not guaranteed a
2 recovery of their costs of doing business. Rather, they have only the right to an opportunity
3 to endeavor to recover such costs through their authorized rates and charges, including a
4 return on their investment. The Commission presumably did not intend to endow them with a
5 higher right or expectation of recovery in conjunction with the transition to retail competition
6 in the generation sector. Nor, as their own policy witnesses have indicated, are they entitled
7 to such an "upgrade." Accordingly, A.A.C. R14-2-1607 (B) should be clarified as suggested
8 above.
9

10
11 Incident to such clarification, the Commission needs to consider and resolve the level
12 of recovery of stranded costs to which the opportunity will apply. Energy Services' proposal
13 contemplates an opportunity to attempt to recover 100% of those stranded costs determined to
14 be appropriate for such purpose. However, that proposal is contingent upon the Affected
15 Utility in question electing to divest itself of its generation assets.¹ In the event the
16 Commission should be asked to allow an Affected Utility to utilize a non-market
17 methodology for calculating the asserted value of its stranded costs, different considerations
18 would need to be taken into account. In turn, those considerations might well warrant, if not
19 require, Commission prescription of a lesser level of recovery opportunity (e.g. 50/50). For
20 example, amelioration of what might otherwise be an impediment to or constraint upon
21 market entry by new entrants would be such a consideration.
22

23
24 B. A.A.C. R14-2-1607 (B) should further be clarified to expressly provide that the
25 commencement of stranded cost recovery by Affected Utilities shall be linked to the
26

27
28 ¹ Energy Services' reasons for recommending divestiture are discussed elsewhere in this Initial Brief. See, for example, the discussion under Issue 3(A).

1 introduction of retail competition. As one witness testified, competition is the "reason 'd
2 entre" for stranded cost recovery. Others observed that it is the onset of retail competition
3 which identifies those economic efficiencies which are to be addressed by such a transition
4 mechanism. Clearly, the Commission had such a causal relationship in mind when it issued
5 Decision No. 59943 on December 26, 1996; and the Electric Competition Rules should be
6 clarified to expressly so provide at this time. In addition, the Commission should preserve the
7 right to require the refund of stranded costs recovered if markets are not fully open by 2003.
8

9
10 C. A.A.C. R14-2-1607 (J) should be modified to provide that stranded costs
11 approved for recovery shall be recoverable from all retail generation customers who remain
12 connected to an Affected Utility's transmission and distribution system regardless of their
13 source of power. There appears to be a consensus on this proposition among the participants
14 in the stranded cost hearings. The only exceptions should be those currently provided for in
15 A.A.C. R14-2-1607 (J), and such variances or exemptions as the Commission may hereafter
16 provide pursuant to A.A.C. R14-2-1615 (C).
17

18 D. A.A.C. R14-2-1607 (G) should be modified to provide for an explicit date by
19 which Affected Utilities shall file estimates of unmitigatable stranded costs. Such date should
20 be as soon as practicable, and designed to allow the commencement of electric retail
21 competition on January 1, 1999, as currently provided in the Electric Competition Rules.
22

23 E. The Electric Competition Rules may need to be further modified or
24 supplemented once the Commission decides how to resolve various of the issues raised in the
25 Procedural Order and the First Amended Procedural Order. Other participants in the
26 "stranded cost" hearings may propose certain changes or additions of such a nature in their
27 respective Initial Briefs. Energy Services will respond to such proposals, if any, as necessary
28

1 or appropriate in its Reply Brief.

2
3 In this regard, Energy Services recommends that the Commission supplement the
4 Electric Competition Rules to prohibit an Affected Utility from constructing or owning
5 electric generation power plants on a regulated basis subsequent to any voluntary generation
6 asset sales it may undertake. If an Affected Utility voluntarily retains ownership of plants,
7 then Energy Services recommends the Commission prohibit construction or ownership of any
8 new plants. Such a prohibition, however, would **not** be applicable to such activities of any
9 unregulated and separate affiliates of the Affected Utility.
10

11
12 Issue No. 2: When should "Affected Utilities" be required to make a "stranded cost" filing
13 pursuant to A.A.C. R14-2-1607?

14 Answer: See discussion below.

15 The resolution of this inquiry will in large measure be influenced by and dependent
16 upon the manner in which the Commission resolves the questions posed by it in several of the
17 other issues set forth in the Procedural Order and the First Amended Procedural Order.
18 Particularly significant among these are Issues No. 3, 4 and 6 which relate to the
19 identification, calculation and recovery of costs deemed to be suitable for the recovery
20 opportunity. Should the Commission adopt Energy Services' proposal that stranded cost
21 recovery be addressed through voluntary divestiture of generation assets and purchased power
22 agreements, the filing date deadline could be 60 or 90 days from the date of issuance of a
23 Commission Decision based on the recently concluded "stranded cost" hearings. In this
24 regard, as Mr. Oglesby noted in his direct testimony with respect to a related matter, the
25 major impact of generation sales resulting from divestiture could be determined in late 1998;
26 and, thus, the basic design of unbundled tariffs could continue on a separate parallel course.
27
28

[See PG&E Energy Services Exhibit No. 1 at page 13, lines 1-2.] Presumably such filing would include information by an Affected Utility electing to divest as to its plans and timetable for sale of the assets in question, including details relating to any auction to be conducted and any releases or consents which might need to be obtained. Conversely, under Energy Services' proposal, those Affected Utilities electing to retain their generation assets on a net depreciated book value basis, with no stranded cost, would so indicate. In any event, it is imperative that the filing deadline established by the Commission be one that is compatible with and in furtherance of the commencement of retail electric competition on January 1, 1999.

Issue No. 3: What costs should be included as part of "stranded costs" and how should these costs be calculated?

Sub-Issue No. 3(A): What calculation methodology is recommended, and what assumptions are made including any determination of market price?

Sub-Issue No. 3(B): Are there any implications of the Statement of Financial Accounting Standards No. 71 resulting from the recommended stranded cost calculation and recovery methodology?

Answer: As to Issue No. 3 and Sub-Issue No. 3(A), see discussion below. "No" as to Sub-Issue No. 3(B) under Energy Services' proposal.

As Mr. Oglesby testified, Energy Services' proposal contemplates nuclear and non-nuclear generation assets, purchased power contracts, regulatory assets, nuclear de-commissioning and one-time generation employee (union and clerical) severance costs as constituting those categories of investment or expenditure suitable for consideration for stranded cost recovery. Depending upon the particular circumstances, employee costs attributable to retraining might also be suitable for inclusion. Additional categories of costs

1 may be proposed by other participants who file Initial Briefs, and Energy Services will
2 comment upon such suggestions as necessary or appropriate in its Reply Brief.

3
4 With regard to the subject of calculation and recovery of stranded costs, Energy
5 Services believes it is imperative that the Commission recognize at the outset that the
6 methodologies adopted for each will dramatically impact the ability of new entrants to
7 compete successfully in the Arizona retail electric market. Thus, for example, the
8 Commission must consciously endeavor to avoid the selection of any calculation or recovery
9 methodology which would enable an Affected Utility to over-recover its allowed stranded
10 costs. This includes precluding the recovery, as a part of the Competitive Transition Charge
11 ("CTC") or "wires" charge, of any fixed costs which should be attributed to generation assets
12 or contracts it is relying upon to provide electrical power in the competitive market. The
13 Affected Utilities should be required to compete on the same terms and conditions as the new
14 entrants, with success being determined by those who are the most efficient and economical.
15 Similarly, the Commission should avoid the selection of any methodology that would give
16 Affected Utilities an ability to control and manipulate market pricing signals, or exclusive
17 control over and use of customer-related information. Furthermore, the Commission should
18 not countenance the use of any methodology or practice which creates the potential for or
19 allows cross-subsidization or market power abuse.

20
21
22 As Arizona Public Service Company Witness John Landon testified during cross-
23 examination:

24
25 Q. In response to another line of questioning from Mr. Meek, you
26 expressed the opinion that new entrants should be required to
27 compete on their own merits in the competitive market, that the
28 incumbent utility should not be disabled in order to allow new
entrants to compete.

1 I'd like to ask you the flip side of that question. And from the
2 Commission's perspective as it is formulating a stranded cost
3 recovery program, are there some things that should be taken into
4 account and be sure to do or not to in order to not tilt the field in
5 favor or in direction of the incumbent utilities?

6 A. Of course there are things the Commission has to do to
7 make sure that the playing field is not tilted against the incumbent,
8 against the entrants.

9 Q. And what would those be?

10 A. I think the primary thing that the Commission has to be
11 concerned with is making sure that there is nondiscriminatory access
12 to essential resources and information so that competitors are, in
13 fact, able to enter the market on reasonably equal terms and
14 conditions with respect to the use of essential facilities.

15 In addition to that, I think the Commission needs to be concerned
16 with setting up an appropriate mechanism to prevent cross subsidies.
17 I think it would be inappropriate and contrary to both good
18 regulatory and good economic principles for the utility to be able to,
19 in effect, tax its regulated customers, DISCO customers, let's say, in
20 order to subsidize its competitive operations or anything else.

21 I also think for a variety of reasons that they wouldn't have any
22 great incentive to do that, but I think it is appropriate to set up
23 appropriate mechanisms to make sure that that event cannot occur.

24 Having accomplished that, I think entry ought to be available to all
25 who qualify and meet whatever standard the Commission may
26 decide to impose on entrants, and I would hope that those standards
27 would be enough to protect the public, but not enough to disable
28 many potential competitors. Because I think the more competitors
that are able to enter and the more robust the market is, the better
the outcome will be to ratepayers and to the people of the state."

[See Tr. 2877, page 17 – Tr. 2879, page 15.]

Thus, in discharging its responsibilities in this area, the Commission must seek to balance and
provide for, to the maximum extent possible, the interests of electric retail customers,
Affected Utilities and new market entrants, respectively.

1 Energy Services respectfully submits that its stranded cost calculation and recovery
2 proposal would address and satisfy several of these concerns. First, voluntary divestiture
3 removes the incentives for vertical market power abuse; and the Commission's oversight of
4 the recommended auction process could also address horizontal market power concerns.
5 Second, sale of generation assets at or above net book value would remove the need for any
6 CTC or "wires" charge as to those investments, thereby eliminating the potential for over-
7 recovery as to the same.² Third, removal or reduction of the need for use of a CTC or
8 "wires" charge would also address the barrier to new entry problem which exists when such
9 charge includes recovery of and return on generation facilities an Affected Utility has retained
10 and is using in order to participate in the competitive retail generation market. Fourth,
11 divestiture effectively removes the potential for cross-subsidization of the retained generation
12 facilities by the Affected Utility's transmission and distribution operations. Fifth, divestiture
13 ensures Arizona will have a competitive generation market as a result of stranded cost
14 recovery. Sixth, divestiture is a "real time" means of establishing the market value of a
15 generation asset or purchased power contract; and, that's what the calculation exercise is all
16 about! Finally, as Tucson Electric Power Company Witness Daniel Fessler observed:
17
18
19

20 "...it sounds to me like there is a great deal of common ground
21 in the statement you just read [quoting from Mr. Oglesby's
22 prepared testimony description of the four basic principles upon
23 which Energy Services' calculation and recovery program is
24 predicated] and what I have opined as my belief as a strategy for
25 this Commission to adopt to bring about a viable and sustainable
26 introduction of competition." [See Tr. 582, lines 16-20.]³

26 ² The over-recovery problem should not exist for regulatory assets, because those values have already been
27 determined by the Commission. While the quantification of nuclear decommissioning costs is less precise, there
28 are guidelines which could be used to minimize the potential for over-recovery of the same.

³ As Witness Fessler further noted, selling electric generation units would be an excellent way of valuing them
for stranded cost purposes. [See Tr. 584, line 21 - Tr. 585, line 5.]

1 Energy Services' proposal does not require mandatory divestiture. Rather, in the event
2 an Affected Utility should prefer to retain its electric generation facilities or purchased power
3 contracts, it has the option to do so. The quid pro quo is that it will forego any claim for
4 treatment of any portion of those assets as "stranded cost." As Witness Fessler acknowledged,
5 Energy Services' proposal reserves to the Affected Utility "an element of discretion" with
6 which to make a business decision as to what to do with such assets. [See Tr. 586, lines 3-9.]
7 Thus, it is the Affected Utility's call as to how to proceed.
8

9
10 Furthermore, Energy Services' proposal addresses the interests of customers and
11 Affected Utilities, respectively, by providing that (i) revenues resulting from sales in excess of
12 net depreciated book value and reasonable costs of sale shall be applied to reduce the amount
13 of any remaining stranded costs; and (ii) any "short fall" resulting from the deficiency
14 between sale proceeds and higher book value shall be recoverable through a CTC or "wires"
15 charge over the recommended four (4)-year recovery period. In addition, Energy Services'
16 proposal provides for evaluation and recovery in the situation where an Affected Utility is
17 unable to dispose of a generation asset (nuclear or non-nuclear).
18

19 With respect to such alternative calculation methodologies as other participants have
20 proposed, Energy Services offers the following preliminary observations. Further and more
21 detailed commentary may be forthcoming in Energy Services' Reply Brief. First, depending
22 upon the circumstances, use of an independent appraisal or a spin-off and related stock
23 valuation may be an appropriate means for establishing a market-based value for purposes of
24 calculating stranded costs. The key characteristic in each of these alternatives is that they are
25 market-based, not administrative cost determination methodologies. Second, Energy Services
26 is firmly opposed to the use of administrative methodologies for stranded cost calculation.
27
28

1 Included among these is the "net revenues lost" approach which several participants have
2 recommended. Given its substantial reliance upon forecasts as to future operating and
3 maintenance costs, market prices and customer load growth, as well as assumptions as to an
4 allowed return on equity, this methodology is fraught with serious problems.⁴

5
6 For example, due to its nature, the "net revenues lost" approach provides no incentive
7 for an Affected Utility to mitigate stranded costs. In addition, it allows recovery of a return
8 on equity on generation which was previously calculated on a different risk analysis basis.
9 More specifically, for stranded cost recovery purposes, the return on equity on generation
10 should be reduced because the risk to the Affected Utility has been reduced.⁵ Furthermore,
11 the "net revenues lost" approach allows for recovery of costs which are not stranded and
12 which instead should be at competitive risk (e.g. market costs). Finally, as other witnesses
13 testified, in addition to the potential for over-recovery, this methodology also contains the
14 potential for overstated stranded costs with an unnecessarily high CTC or "wires" charge
15 which may impair or preclude the ability of new entrants to effectively participate in the
16 competitive market.
17
18

19 Depending upon the discussion set forth in Initial Briefs filed by other hearing
20 participants, Energy Services may further discuss the deficiencies of administrative-based
21 calculation methodologies in its Reply Brief.

22 With reference to Sub-Issue No. 3 (B), as Arizona Electric Power Cooperative Witness
23 William Edwards and Tucson Electric Power Company Witness Karen Kissinger
24

25
26 ⁴ Illustrative of such criticisms is the testimony of Commission Staff Witness Kenneth Rose. [See Staff Exhibit
No. 2 at page 3, lines 12-19; and page 6, line 25 - page 7, line 2.]

27 ⁵ Illustrative of recognition of the need for such a realignment was the action of the California Public Utilities
28 Commission when it reduced the return on equity to be allowed on generation, for stranded cost recovery
purposes, to 90% of the cost of debt.

acknowledged during cross-examination, there would not be an adverse consequence for Affected Utilities in relation to FAS 71 under Energy Services' recommendation of a 100% structured cost recovery opportunity.

Issue No. 4: Should there be a limitation on the time frame over which "stranded costs" are calculated?

Answer: Yes. See discussion below.

Under Energy Services' divestiture proposal, there would not be a need for a forecasted period of calculation in the event of a sale with net proceeds equal to or above net depreciated book value. If the net proceeds were less, then Energy Services proposes recovering the difference between costs and purchased power for meeting Standard Offer for a four (4) year period beginning January 1, 1999. Alternatively, if the Affected Utility elects to retain the asset in question at net depreciated book value, then there is no stranded cost with which to deal. Furthermore, as previously noted, with regard to regulatory assets and nuclear decommissioning expense, the cost calculations have either already been determined or are largely in place at this juncture.

With regard to any other cost calculation methodology which might be considered by the Commission, Energy Services recommends as a general proposition that the use of any forward looking projections be limited as much as possible, due to the uncertainties and vagaries inherent in such methods. Depending upon the arguments advanced in Initial Briefs, by hearing participants, Energy Services may discuss this issue further in its Reply Brief.

Issue No. 5: Should there be a limitation on the recovery time frame for "stranded costs"?

Answer: Yes. See discussion below.

In connection with its proposal, Energy Services has recommended a recovery period

1 of four (4) years. Even if Energy Services' divestiture proposal should not be selected as the
2 Commission's exclusive or preferred calculation approach, Energy Services still recommends
3 a recovery period not to exceed three (3) – five (5) years. As a number of witnesses testified
4 during the recently concluded hearings, the sooner the transition to a competitive market is
5 completed, the better for all concerned, be they retail electric consumers, Affected Utilities or
6 new market entrants.
7

8
9
10 Issue No. 6: How and who should pay for "stranded costs" and who, if anyone, should be
11 excluded from paying for "stranded costs"?

12 Answer: See discussion of Issues No. 1 and 3 above.

13
14 Issue No. 7: Should there be a true-up mechanism and, if so, how would it operate?

15 Answer: See discussion below.

16 Energy Services' proposal does not need a true-up mechanism. However, as a general
17 conceptual matter, Energy Services does not oppose the inclusion of a true-up mechanism as
18 part of a stranded cost recovery program, provided certain concerns it has are addressed and
19 provided for. First, the recovery period should still be within the time frame parameters
20 discussed above, namely, three (3) – five (5) years. Second, the presence and operation of a
21 true-up mechanism should not endow the Affected Utility using the same with any
22 competitive advantage vis-à-vis new market entrants with whom it may be competing. Third,
23 use of a true-up mechanism should not be allowed if it has the potential to confuse or
24 intimidate consumers, thereby inducing them to avoid seeking pricing alternatives in the
25 competitive market. For example, a true-up should not be authorized if there is any potential
26 for a customer having to pay more as a consequence of the presence of this type of
27
28

1 mechanism than would otherwise be the case during the transition period. The uncertainty
2 resulting from such a situation could clearly inhibit competition. Finally, any true-up
3 mechanism allowed should be intentionally designed to preclude the occurrence, if not
4 prospect, of over-recovery.
5

6
7 Issue No. 8: Should there be price caps or a rate freeze imposed as part of the development
8 of a stranded cost recovery program, and, if so, how should it be calculated?

9 Answer: See discussion below.

10 Energy Services' proposal does not include a "price cap" or a "rate freeze."
11 However, Energy Services strongly believes that residential and small commercial customers
12 should be protected from utility rate increases during the transition period. Under no
13 circumstances should rates for any customers in any class be increased as a result of stranded
14 cost recovery. If the Commission should conclude a rate cap is necessary to prevent utilities
15 from raising rates, then one should be imposed. Depending on the arguments advanced by
16 other participants in their Initial Briefs, Energy Services may discuss this topic further in its
17 Reply Brief.
18

19
20
21 Issue No. 9: What factors should be considered for "mitigation" of stranded costs?

22 Answer: See discussion below.

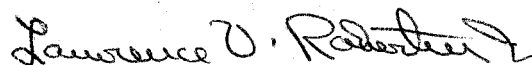
23 These factors are discussed at some length in Mr. Oglesby's prepared direct testimony.
24 In the interest of brevity, that discussion is incorporated herein by reference. [See PG&E
25 Energy Services Exhibit No. 1, page 24, line 1- page 26, line 22.] Depending on arguments
26 made in response to this issue by other hearing participants in their Initial Briefs, Energy
27 Services may address this subject further in its Reply Brief.
28

LEGAL ARGUMENTS

In response to the invitation of the Chief Hearing Officer, Energy Services has no legal arguments it desires to submit in connection with its Initial Brief. It reserves the right to submit legal arguments, if necessary, in connection with its Reply Brief.

DATED: March 16, 1998

Respectfully submitted,



Lawrence V. Robertson, Jr.
MUNGER CHADWICK, P.L.C.
National Bank Plaza
333 N. Wilmot, Suite 300
Tucson, Arizona 85711
Attorney for PG&E Energy
Services Corporation